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THE EXHAUSTION PRINCIPLE COMES IN THE WAY OF PARALLEL IMPORTERS

Some comments on the *Silhouette* Judgment (delivered by the European Court of Justice on the 16 July 1998)

1. The facts in the *Silhouette* case

An Austrian Court, seized with a dispute between two Austrian companies, Silhouette and Hartlauer, sought the assistance of the European Court of Justice in Luxembourg, through a preliminary reference. Silhouette, a manufacturer of top of the range branded spectacles sold its product to a company established in Bulgaria on condition that they would not be resold elsewhere, including the European Economic Area. Hartlauer, a discount outlet in Austria, sought to obtain Silhouette spectacles from the brand owner, but was turned down because of the down-market image of the outlet. On being refused supply, Hartlauer succeeded in sourcing genuine Silhouette spectacles from Bulgaria on the grey market and imported them into Austria for resale from his discount outlet. In an effort to protect the image of the spectacles, Silhouette sought an injunction before the Austrian courts to stop Hartlauer from offering the spectacles for sale in Austria.

Since the matter turned on the interpretation of a provision of the European TradeMark Directive, the Austrian Court referred a question to the European Court of Justice, in virtue of the preliminary reference procedure under Article 177 of the EC Treaty.

2. The points of law at issue

Silhouettes' claim was based specifically on Article 7(1) of the European Trade Mark Directive which lays down the so-called principle of exhaustion, that is,

a trade mark owner loses his right to prohibit the resale in the European Union of his branded goods as soon as he himself sells of consents to the sale of those goods anywhere in the European Economic Area territory. The EU exhaustion principle has been a firmly established principle in EU law regulating intellectual property rights and the Directive in question simply crystallises this well-known doctrine.

However, the set of circumstances before the Austrian judge required him to go beyond the state of evolution of the exhaustion principle as it stood then since it involved a country which was not within EEA territory, namely Bulgaria. In other words, neither the Directive nor established case-law had a ready answer to the question of whether the trade mark owner exhausts his right to prohibit resale of his branded goods in the EU if he sells or consents to the sale of the goods in a country outside the EEA. Hence, the need for clarification on whether the "international exhaustion" principle applied. This was the first point of law at issue.

A second, though, supplementary point, related to whether Member States were precluded from adopting the wider rule of international exhaustion in their national legislation implementing the Community Directive. [Member States are required to implement the provisions of European Directives by enacting national legislation in order for them to be effective in their territory]. In the pre-Silhouette scenario there were at least, three ways in which Member States dealt with the situation. Denmark and the U.K. simply reproduced the language of the Directive about exhaustion in their national legislation leaving the national courts to interpret the wording. France and the Benelux countries specifically outlawed the application of the international exhaustion principle. A third group of countries, including Sweden, the national law, which already provided for international exhaustion, was left intact by national legislation implementing the Directive.

3. The judgment of the European Court of Justice

The Court settled these two points in the following manner:

a) Regarding *international exhaustion*, it clarified that under the Directive, exhaustion only occurs when the goods have been placed on the EEA market by the trade mark owner or with his consent. Thus, where the goods are placed

on the market in a country outside the EEA, exhaustion does not apply, so that the trade mark owner can legitimately stop the resale of the goods into the EU (provided that he has not consented to their being sold in the EEA). International exhaustion, therefore, did NOT apply in the EU.

b) Regarding *adoption of international exhaustion by the Member States in their national legislation*, the Court ruled that Member States were precluded from adopting such a principle since the resulting discrepancies between the Member States would create barriers to the free movement of goods and services within the EU internal market. Therefore, all EU countries must now apply only a Community exhaustion principle and Member States were required to adjust their legislation accordingly. The Court specified that the EU would only be able to extend the exhaustion principle to products put on the market outside the EEA through international reciprocal agreements. *Meanwhile, the position is that brand owners are entitled to stop genuine branded products from being imported into the EU from any country outside the EEA, provided that neither the brand owner nor any licensee had consented to such import.*

4. Comments

This judgment has been the subject of controversy in the press and in academic writings. Most significantly, it provoked the wrath of large supermarkets and consumer associations in the U.K., which were in the middle of waging a "brand war" against the high prices charged for branded goods. By and large this judgment has been denounced as a step backwards in terms of consumer rights as it severely limits the ability of grey importers to source consignments of branded goods from third countries (outside the EEA area, notably the U.S.) without the consent of the relevant brand owners or licensees.

To these comments, I would like to add a few observations about the Court's ruling.

i. *Confirmation that the doctrine of exhaustion has territorial limits*

The Court judgment leaves no doubt as to the correct interpretation of Article 7 of the Community Directive regulating trademarks, namely that as long as branded goods were put on the market **outside the European Economic Area**,

even if this was done with the consent of the owner of the mark or by third parties with his consent, there is no exhaustion of the trademark rights. In other words, a trademark owner (of owner of a design, as in this case) may invoke his industrial property rights to prohibit the importation and sale of branded goods in the EEA if these goods were sourced outside EEA.

The implication of these parameters may be appreciated if one contrasts this ruling with the situation obtaining INSIDE the external borders of the internal market. Here, parallel imports are fiercely protected and no rights deriving from intellectual property could come in the way of the free importation of trademarked or designer goods from other Member States even if these were obtained from third parties and not directly from the owner of the mark. All this is done in the name of guaranteeing so-called intra-brand competition (competition between goods of the same brand-name). In the internal market scenario where the overriding objective of competition is considered to be the market integration goal, the doctrine of exhaustion was the Court's response to the need of striking a balance between, on the one hand, discouraging the fragmentation of the single market along national borders through the use of national industrial property rights and on the other hand, guaranteeing rewards for innovation.

In plainer language, intellectual property rights may not be successfully invoked to impede trade of goods originating in the Community, as long as the mark has been exhausted there, yet on the other hand they may be used to stop authentic goods sourced in third countries. Does this perhaps substantiate the view that the EU is a Fortress Europe? In other words, are intellectual property rights being deployed as instruments in restraint of trade with third countries? It seems that the Union is keen on discriminating simply on the basis of origin and it is deploying intellectual property rights to achieve its objective. The irony in all this is that, in my opinion, it is Community industry itself which is being kept out in the cold!

ii. *Restriction of price competition in the European market on designer goods*

In innumerable judgments of the Court of Justice and decisions of the European Commission in competition law cases, the importance of the guaranteed presence of price competition on the European market was emphasized. In fact selective distribution systems where luxury brand owners would attempt to secure price levels as well as an exclusive image for their brands,

would be slammed as illegal if it transpired that these networks were used to discriminate against and keep out price discounters. *Some* degree of price competition is crucial for effective competition in the relevant market.

Again, this judgment seems to be imposing territorial limits to this European creed. This judgment has virtually eliminated the possibility of having ANY kind of price competition in designer brands in Europe since price discounters have now been discouraged to tap cheaper designer goods which are invariably sourced outside the common market. The inferences could be two:

a. Price competition in the internal market, according to the Court, is positive only when this originates from within the Community (or EEA) - (This of course is an aberration since you cannot have effective price competition if you put territorial limits on where this should be coming from. Is this policy conducive to the enhancement of consumer welfare, which should be the primary objective of competition law ?)

b. The Court may be signaling that, rather than relying on low-priced grey imports sourced from outside the Community to guarantee a degree of price competition in the designer goods trade in the EU, manufacturers should instead seek to loosen their stranglehold on retailers by allowing them more freedom to set their own price levels. Hence an increase in price competition. If this is a correct reading, this is not a bad proposition at all.

It is hoped that the latter observation is the correct one and that the Court of Justice will, in the near future, have the opportunity to develop this trend in its pronouncements. If, on the contrary, the former observation is true, then I fear that this judgment goes a long way in cushioning European industry from pressures of competition coming from outside its external borders. This is bad news both for the European consumer as well as for European industry.

iii. *Manufacturers' power over sales chain set to increase.*

The expected aftermath of this judgment is that manufacturers or owners of brand names will tighten their control (thus restricting competition) over the price-setting and the location and methods of selling of their retailers. Moreover, this judgment should be analysed against the background of recent developments (Commission Communication on the application of EU competition rules to vertical restraints, published on 30 September 1998, IP 98/853) whereby

the Commission, in a radical review of its traditional policy on vertical restraints, has adopted a new approach. From now onwards exclusivity deals that fall below certain market thresholds are not deemed to be a threat to competition and therefore are able to avoid the scrutiny of the Commission watchdog for competition, namely DG IV. These two developments have sent shivers down the spines of grey importers (typically large supermarkets) as they claim that the net effect will be the tightening of the manufacturers' powers over them.

Should a distributor of a luxury branded product in a selective distribution network not be able to set his/her own price levels as long as the exclusive image of the brand name and its reputation are preserved? Should he/she not be able to source cheaper (authentic) versions of the goods in question from a third country if this in effect results in a better promotion of the goods with his/her customers who are willing to pay less for the good in question - perhaps less than what other customers in other areas of the common market are prepared to pay? Is not this what diversity in the single market is all about? After all, it is an undeniable fact that not one single good is marked with the same price throughout the single market, as it has already become more evident for all thanks to improved price transparency throughout the EU following the launch of the Euro on January 1st of this year. Effective competition is not about uniform pricing throughout the Community but it is all about setting the right price for the right market or part thereof.

I fear that this judgment is lending support to the idea that price competition should be sacrificed on the altar of preserving the image of a designer good through the maintenance of high pricing. If this idea is allowed to run wild, consumer welfare will be seriously undermined.

iv. *What concept of competition is this judgment promoting?*

This latter observation brings me to this broader issue. Is this judgment promoting the objective of maximising consumer welfare through efficiency? Or is it perhaps giving more importance to the objective of market integration, in the sense that competition law is used as an instrument of consolidating the internal market as one unified whole by removing all internal barriers to trade but reinforcing the external borders?

A restriction on price competition is definitely not promoting consumer wel-

fare in the branded goods market. It is also doubtful how far this restriction may be justified as being necessary to safeguard innovation. In other words, what should prevail, the consumer's right to have real price competition no matter the origin of the goods or the innovator's right to protect his/her creation ? Surely this is a matter of proportionality - finding the right balance. Or perhaps this principle too has its territorial restrictions?

5. A ray of hope?

There is one saving feature to this judgment: the Court has clearly left open the possibility of future negotiations with third countries with a view of extending the EU exhaustion principle to one of "international exhaustion". As is customary in all international trade negotiations, however, this development will only take place on the basis of reciprocity - that is, only in so far as the third countries concerned are able and willing to offer the same openness in their home markets. A long and winding road is clearly ahead, if at all.